

DOW THEORY LETTERS INC.

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Letter 381

THE MARKET: The biggest financial story of the generation is drawing steadily towards conclusion. That story is gold—and the staggering problems of the dollar. If readers feel I am writing too much about gold, let them ponder this. The gold story is assuming almost daily headline status. It is affecting almost every corner of American life, from travel to interest rates, from foreign investments to U.S. financial freedom, from our conduct of the war, to the actual credibility of our politicians. I do not think I am writing too much about gold. I do not think too much can be written about gold at this time.

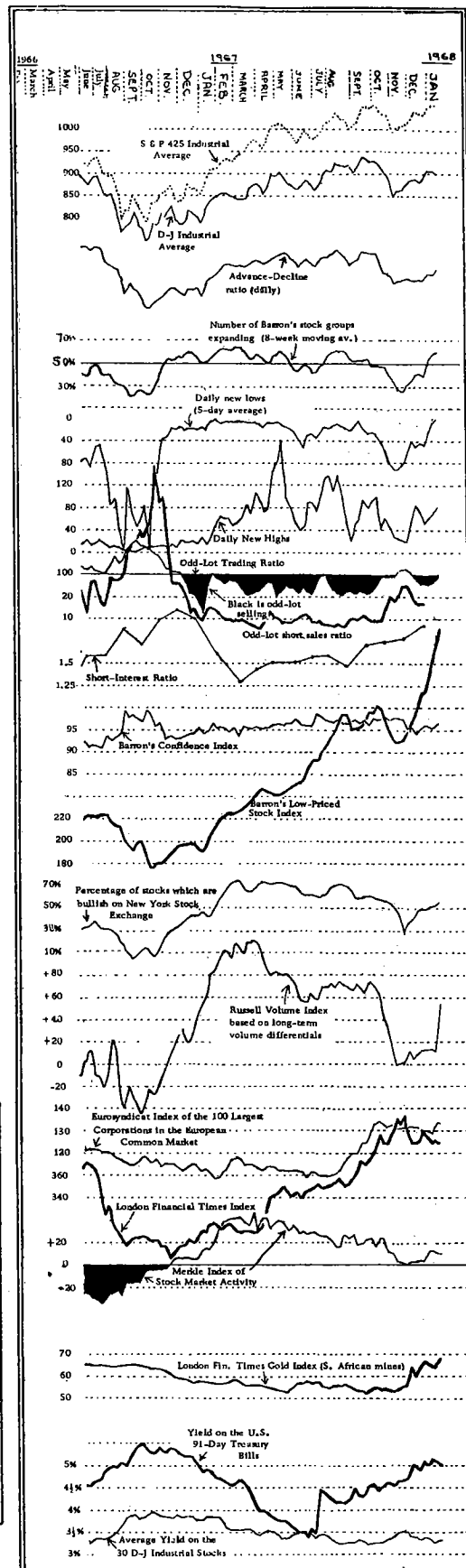
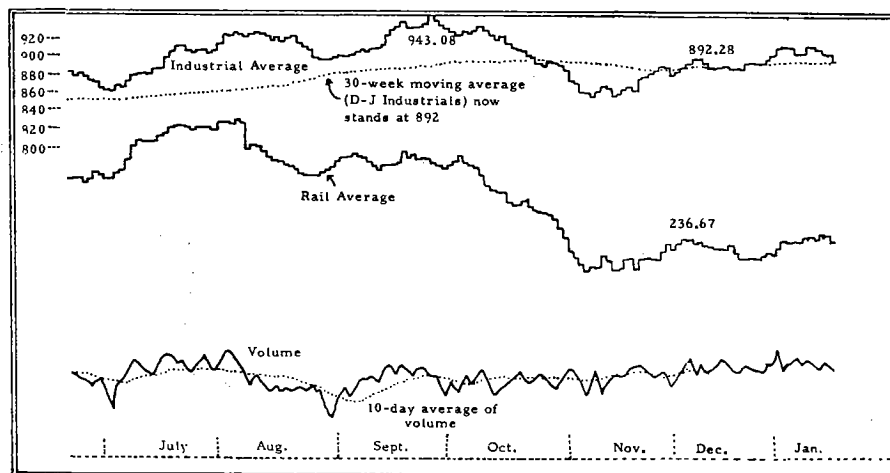
On Wall Street the market has twisted itself into a unique technical puzzle. On January 8 the Industrial Average rallied to a post-November high of 908.92. On the same day the Rail Average confirmed by bettering its late-November high of 236.67. Then, instead of extending the advance as might be expected, the Industrials suddenly slid off, breaking below 900 on January 11. Further confusion was added when the advance-decline line continued higher, rising to new post-November highs despite the fact that the Averages were sinking or hesitating.

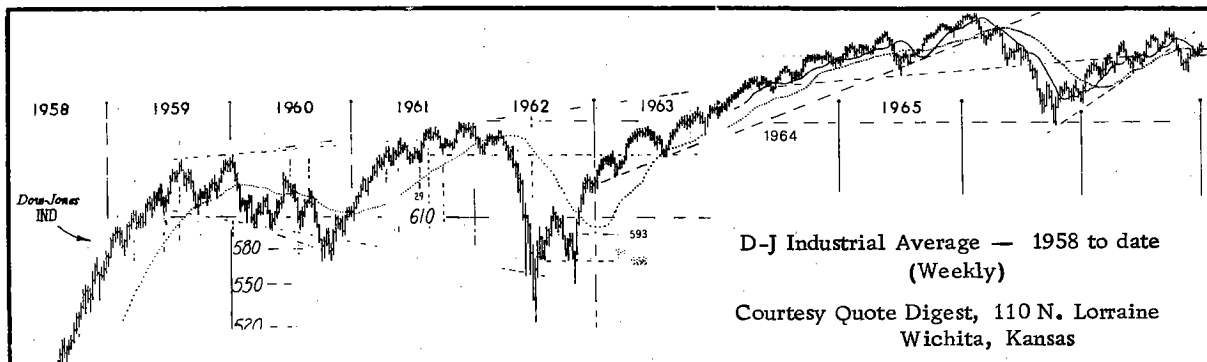
Ordinarily, I would consider the current picture positive, one of more strength than weakness. One could make a case for the Averages "correcting" slightly, while the bulk of the market (i.e., A-D ratio) continued to rally. Nevertheless, I continue to take a cautious attitude toward the near-term. It is well to note that the current divergence is occurring within the context of a primary bear market, and divergence and non-confirmations within a bear market are never to be disregarded.

It is now assumed that LBJ will ask removal of the 25% gold cover behind U.S. currency in his State of the Union speech. No one, at this time, can forecast world reaction to either a removal or a failure to remove the gold cover. I feel much of the market's present "nervousness" is due to investment concern regarding action (or inaction) on this issue (see later comments in this Letter).

Overall, the market appears to be suspended in equilibrium with the greatest concern being shown among blue-chip or investment shares despite speculation in sundry high-flyers.

Meanwhile, the most intense hoarding of gold is occurring throughout the world. In France alone, it is estimated that Frenchmen (who are deathly afraid of





devaluation) have now hoarded \$10 billion in gold bullion, this on top of the more than \$5 billion in gold held in French monetary reserves. So great is the demand for gold coins (of "numismatic value") that expert Franz Pick estimated that \$100,000 to \$200,000 worth of assorted gold coins are being smuggled into the U.S. each day.

Communist China is another big hoarder of gold and for more than a year China has been selling sterling for gold bullion. In India the going black market price for gold runs above \$70 per ounce. In Miami, the President of A & G Refining Co. stated that he now receives from 15 to 20 inquiries per day regarding the possibility of purchasing gold bullion. Thus, the world movement to gold hoarding continues. The biggest commodity bargain of the day is being hidden, hoarded and hedged away by worried speculators, investors and collectors.

BIG PICTURE: A great many disparaging remarks have been aimed at studies of the "big picture." One old Wall Street adage has it that there is no long term, that the long term is simply composed of many short and intermediate term trends. It was Lord Keynes who noted that "In the long term we are all dead." Nevertheless, I have always felt that a knowledge of the long-term picture is informative, and usually essential.

The accompanying chart traces the path of the Dow from 1958 to the present. To me the most striking thing about the recent action is that the Dow has sustained no real progress for the past four years. To put it another way, I have listed the peak closing prices of the Dow since the year 1965. The 1965 high was 969.26, the 1966 peak was 995.15, and the 1967 high was 943.08. Thus for the past three years (actually four if we consider 1964 with a 1964 peak of 891.71) the thirty investment-quality Dow stocks have been fluctuating within a range bordered by 995.15 at the 1966 peak and 744.32 at the 1966 low. Within this 251 point area we have seen the heaviest volume and probably the most intense and concentrated speculation in Exchange history. (The week ending January 12, in fact, saw the heaviest volume in N.Y.S.E. history with January 12 bringing the heaviest single day's volume in Amex history).

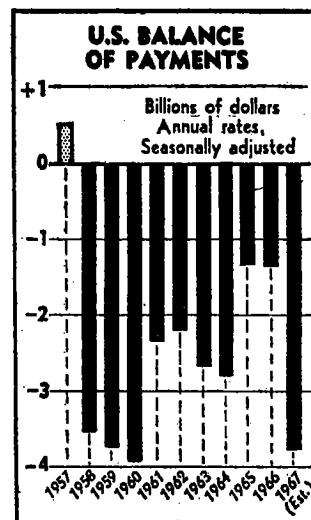
My own feeling is that the whole 1965-68 area is developing into one of the most massive market tops in Wall Street annals. During this period interest rates have risen to century-mark highs, America has lost a major portion of its gold savings, foreign claims against our gold have built up to mountainous proportions, a major war is on and growing bigger and more expensive, inflation has run rampant, numerous foreign currencies have been devalued, pressure is building up against the dollar, restrictions against U.S. business are increasing. Finally, the openly-espoused reason for speculating in common stocks is "to hedge against inflation." In all history, the poorest reason for purchasing common stocks is as an inflation hedge following an actual long period of inflation.

Remember, inflation has been with us for two decades. Inflation is now being accepted as inevitable by the American public. People who ten years ago had not the slightest interest in buying real values are now purchasing all types of equities on the basis of inflation. This when a majority of factors suggest that deflation is looming on the horizon.

I include a little chart which dramatically portrays one of the U.S.'s most pressing problems, its balance-of-payments. With the war expanding, with domestic expenses rising, I doubt whether 1968 is going to look any different than 1964, 1965 or 1967.

This chart shows us the elements for either (1) a dramatic move by the U.S. to restrict overseas expenses, a move which is loaded with adverse political pressures, or (2) a revaluation of the money base via a substantial increase in the price of gold. If the first is followed, ironically, a European slump is almost assured, together with contracting world trade and a probable call for a gold price rise which will (it is hoped) stimulate world trade again.

Therefore, the only single element which I see could hurt gold shares would be an ending of the Vietnam war. In the next section of this Letter, I outline the reasons why I do not believe this will occur any time soon. Quite the contrary, I agree with my friend Eliot Janeway when he states in his latest report, "The odds are heavily stacked in favor of a massive escalation beyond the present scope of the war by March."



VIETNAM: I believe that Americans in general make one major mistake regarding the Asiatic Communists; they underestimate their patience. The Vietnamese have invested decades of manpower, blood and sweat in the Vietnam situation, and I do not think they are about to negotiate or settle out of any feeling of desperation.

Hanoi is well aware of both the economic and political situation in the U.S. They are well aware of the fall of the pound, the pressure on the dollar, the dislocations caused by our war spending, and they are certainly aware of the mounting popular and political pressure to end the war.

Do the Communists really want to negotiate now? It is true that LBJ is "foaming at the mouth" to get the war over, but the nearer we get to election time the more the pressure will be on LBJ. Hanoi is probably trying to gauge LBJ's chances of winning the election, and obviously his chances are still very good. I believe that Hanoi would rather deal with a President other than LBJ, but they cannot count on this opportunity presenting itself. Therefore, they must believe that they will ultimately have to deal with a pre-election LBJ or a post-election LBJ. Nevertheless, the nearer we get to election, the more pressure on LBJ, and it seems to me that if Hanoi was serious about ending the war they would prefer to get serious within a few months of actual election time in the fall of 1968.

Yet, what has Hanoi got to lose by "acting" as if it wishes to get the war over with and negotiate? The mere issuing of rumors regarding Hanoi's negotiation-wishes puts added pressure on the Johnson administration. It provides ammunition for the doves. If we do not take the Communist "feelers" seriously every dove in the nation starts pointing accusing fingers at the Administration. Peace feelers arouse hopes among the U.S. populace, and if the negotiations do not come about, if we do not stop the bombing of North Vietnam, then frustrations mount and discontent swells.

Therefore, after mulling over the whole situation I conclude that if I were running Hanoi I too would issue peace feelers every three or four months just to see what I could "shake out of the tree." And it is clear that the Administration is now under such pressure that they must take the peace-feelers very seriously. This is something which has not been apparent before.

The stock market appraised the peace-feelers in much the same way that I do. On the initial news, the Dow dropped 10 points, but before the day (January 4) was over the Dow had cut its loss to 5 points. The next day the market rallied. The market shows itself less and less vulnerable to Hanoi's peace rumors, and I believe it is correct. It does not appear logical to me that the Communists are willing to negotiate seriously at this time. I would be more prone to believe that they are again shaking the tree and holding out a "carrot". I do not think I am cynical when I say this. I believe I am simply dealing realistically with the Communist strategy. After all, what in the world can they lose by appearing to be ready to talk?

NEW YEAR: Here we go into 1968, and I believe that this is going to be a most dramatic year, a year of many crises, and I am talking about monetary crises. President Johnson set the crisis machinery in motion when he announced the new set of restrictions against the dollar. These new mandatory controls will automatically hit the European economies and particularly Britain with its newly devalued pound.

A number of nations are now suffering in the wake of British devaluation, it is only a matter of time before they too join the devaluation parade. The switch from voluntary to mandatory controls over foreign investments will have a depressing effect on European business. A large part of the total investment in the Common Market and Outer Seven has come from the U.S. It has been U.S. financed. A cutback here is going to send Eurodollar rates sharply higher, and it is going to cause a worldwide slump. Perhaps the first hint came last week when the Japanese bank rate was quietly boosted from 5.8% to 6.2%.

Here are some of the other phenomena which I expect to appear in 1968: France will put further pressure on the dollar in any way she can. Her trump card remains a devaluation of the franc.

The Federal Reserve Board will remain in a real quandry as to what to do on the interest rate and money supply front. As seen on the chart on page 4 (courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y.) the Fed has since late last year inaugurated a policy of less expansive credit, and should this result in higher interest rates, the continuing cost-price inflation in the face of rising interest rates will probably throw the Fed into a further quandry. In the meantime, LBJ can use either Congress or the Fed or both as the "whipping boys" when the new round of monetary troubles arrives. The public is now so confused about the money situation that it is ready to believe almost anybody, yet is sceptical of everybody.

International trade will contract, and trade competition will reach the vicious stage. U.S. imports will climb as prices here rise and as the rest of the world enters extreme competition for U.S. sales.

As Europeans are forced to raise more of their own capital and so Euro-money rates climb, Europeans will put pressure on

Page 4 the U.S. to raise the price of gold multi-laterally, and thereby attempt to solve the world monetary problems. It should be remembered that any successful attempt to balance the U.S. balance of payments is going to hurt the rest of the world severely.

The squeeze is going to continue on U.S. corporate profits and it will be increased by either a tax surcharge or an attempt to limit the size of the domestic money supply. Either one of these contingencies will have the effect of boosting the domestic budget deficit by cutting the size of the Treasury's tax-take from corporate profits.

I expect another rise in interest rates, this time to new highs as the next monetary crisis develops in Europe and the U.S. This time it will be joined by a worldwide business contraction and a renewed gold crisis, together with a profit squeeze and vicious price competition from Europe.

NOTES AND QUOTES: Last week the Federal Reserve Gold Ratio dropped to a new low of 27.1%, 2.1% above the legal limit of 25%. Obviously something will have to be done in a hurry. "At its present rate of descent," say my friends at Indicator Digest, "the Ratio should be below the statutory 25% before the end of next month."

All very well. But then I read this week's Business Week (Jan. 6) and I note not without surprise: "Some facets of the defense of the dollar that could prove prickly in Congress either will be sidestepped for the moment or softened. The idea of lifting the gold cover—is being put on a back burner. Some member of the Administration felt the President's program would be more convincing abroad if Congress were asked to abolish it. White House soundings indicate that Congress would quickly comply. But it was decided not to risk the outcries of conservatives."

Now I assume that Business Week has top Washington pipelines. If what they say is true, it's rather exciting. What happens next—when the Gold Ratio drops under 25%? Is the Administration secretly planning to embargo gold? Are there secret arrangements for doubling the price of gold? If Business Week is correct, and if the current trend in the Gold Ratio continues, something has got to give! At any rate, this is why I advocate holding gold shares.

Public opinion, it should be noted, is slowly changing in favor of "it might be good if we raised the price of gold." Last week U.S. News & World Report wrote favorably about a gold price hike. Other leading publications are beginning to see the advantage of a world revaluation of gold. Meanwhile, the fundamentals stand out like a beacon. Said American Institute for Economic Research, ".....as long as the U.S. continues to sell gold at \$35 per ounce, the world's greatest bargain sale can continue. What else offered in the markets of the world is available at pre-World War II prices.?"

GOLDS: The gold shares are beginning to act differently. They are not responding to the sort of news which has (in the past) shoved them into important corrections. Over the past few weeks the pound has rallied, the dollar price of gold has slid off 5¢, and the U.S. has released its barrage of balance-of-payments propaganda with much pious talk about defending the dollar. In the face of this, the South African gold index (see page 1 chart) had hardly budged downward, and most of the big gold stocks (Dome, Campbell, Homestake) have undergone only token declines.

My own feeling is that the golds are now in strong hands, and that the public and a few funds are nibbling on the small floating supply. Technical Stock Reports (Palisades Park, N.J.) issues estimates of the floating supply of most N.Y.S.E. issues. The floating supply is considered the difference between the total number of shares issued in a given company and the number of shares closely held. Here are the figures on leading gold shares: Campbell Red Lake....1.7 million shares, Dome....1.7 million, Homestake....2.3 million shares, American South African....2.4 million shares. As contrast American Cyanamid has 41 million shares in floating supply, Chrysler 43 million shares, Inland Steel 15 million, Sperry Rand 27 million.

Thus a mild amount of interest and an increasing interest in gold shares can absorb much of what comes on the market for sale. This, I believe, is one of the reasons that the reactions in the gold shares are becoming milder and milder while rises are growing larger and larger.

QUOTE OF THE WEEK: From the conservative Cleveland Trust Company bulletin just received: "Make no mistake about it, the chances of the dollar surviving another year on promises but without progress in its balance of payments position are not good."

